

Bills Committee on Inland Revenue (Amendment) (No. 6) Bill 2017

Government's Response to Submission from Members of the Public

A submission has been made by some members of the real estate sector to the Chairman of the Bills Committee seeking clarifications on the Committee Stage Amendments (“CSAs”) proposed by the Government to section 50AAJ in the Inland Revenue (Amendment) (No. 6) Bill 2017 (“the Bill”). This paper sets out the Government’s responses for Members’ reference.

Overall response

2. To address the stakeholders’ concerns over the compliance burden on businesses arising from the application of transfer pricing (“TP”) rules to domestic transactions and having regard to the prevailing practice of the Inland Revenue Department (“IRD”) in considering the overall Hong Kong tax position of the transactions involved in the application of TP rules, the Government has proposed to move CSAs to section 50AAJ. A marked-up version of the relevant CSAs, which were discussed by the Bills Committee at the meeting of 14 May 2018, is at **Annex**.

3. Specifically, the proposed CSAs seek to **reflect the policy intent** that, insofar as domestic transactions between associated persons **do not give rise to actual tax difference** (or domestic transactions involving non-arm’s length loans (e.g. interest-free loans) are not carried out in the ordinary course of money lending or intra-group financing business), and provided that such transactions do not have a tax avoidance purpose, then the relevant persons will **not** be obliged to compute the income or loss arising from these transactions on the basis of the arm’s length provisions in their tax returns and **no** corresponding assessment on that basis will be made by IRD.

4. We consider that the proposed CSAs have **addressed stakeholders’ concerns and minimised the compliance burden of the business sector**. In particular, the no actual tax difference condition has all along been

adopted by the Government throughout the discussions with the Bills Committee as one of the conditions for relieving certain domestic transactions from the application of TP rules. In short, the associated persons will be relieved of the need to make TP adjustment and claim corresponding relief of equivalent amounts in respect of the same domestic transaction between them given that the effects of such adjustment and relief will counteract each other. Hence, TP adjustment will be required if the actual provision confers a potential advantage in relation to Hong Kong tax on an affected person whereas no corresponding relief is allowable to another affected person. Whether or not the provision is “disadvantageous” to both affected persons as a whole from the tax perspective (i.e. the “tax disadvantageous situation” quoted by members of the real estate sector in the submission) is **not** a relevant consideration. We consider that the formulation of section 50AAJ as revised by the proposed CSAs serves to reflect our policy intent which is simple in design and easy for taxpayers to understand.

5. To help the business sector and other stakeholders better understand how the TP-related provisions should be applied, IRD will provide further guidance in its Department Interpretation and Practice Notes (“DIPN”) after the Bill is passed by the Legislative Council. To put the proposed CSAs in context, we set out in the ensuing paragraphs the key underlying principles and our responses to the specific issues raised in the submission for Members’ reference.

No Actual Tax Difference Condition (Section 50AAJ(5))

6. Under section 50AAJ(5), the no actual tax difference condition is met if –

- (a) each affected person’s income arising from the relevant activities is chargeable to Hong Kong tax or each affected person’s loss so arising is allowable for the purposes of Hong Kong tax; and
- (b) no concession or exemption for Hong Kong tax applies to any affected person’s income or loss arising from the relevant activities.

7. Section 50AAJ(5)(a) seeks to ensure that the income or loss of the affected persons from the relevant activities is to be brought into account for the purposes of Hong Kong tax. A person is regarded as having a **“loss allowable”** for the purposes of Hong Kong tax if he sustains a loss (i.e. taxable income is less than allowable deductions) from the relevant activities. Having such a loss brought forward from previous years of assessment is **not** a pre-requisite for meeting the condition.

8. Furthermore, if the actual provision does not confer a potential advantage in relation to Hong Kong tax within the meaning of section 50AAJ(1), the TP rules will **not** come into play and it is therefore **not** necessary to consider whether the no actual tax difference condition under section 50AAJ(5) is met. Internal transfer of investment property between two affected persons is a relevant example. Where the relevant provision involves non-taxable capital gain and non-deductible capital expenditure and hence does **not** result in a smaller amount of taxable income or a larger amount of tax loss for either of the affected persons, there is no need to consider TP adjustment.

9. In the case of property development, a person will be regarded as having an income arising from the relevant activities chargeable to Hong Kong tax or a loss so arising allowable for the purposes of Hong Kong tax if he/she borrows a sum of money from an associated person to acquire land and construct a property thereon for sale or business purposes. In such situation, the interest expenses incurred are usually capitalised and deductible as part of the cost of trading stock or by way of commercial building allowance (“CBA”) / industrial building allowance (“IBA”)¹. Provided that no concession or exemption for Hong Kong tax applies to the income or loss of the lender and the borrower arising from the relevant activities, the no actual tax difference condition is met.

¹ If the property is used for sale, the capitalised interest relating to the acquisition of the land and the construction of the property will form part of the cost of trading stock and be deductible upon the sale of the property. If the property is for self-use or letting purposes, depending on whether the property is used by the borrower or the lessee for qualifying trades (e.g. manufacture or storage of goods, farming, scientific research, etc.), the borrower is entitled to claim CBA (annual allowance at 4%) or IBA (initial allowance at 20% and annual allowance at 4%) in respect of the capital expenditures (including the capitalised interest) incurred for the construction of the property.

Non-business Loan Condition (Section 50AAJ(6))

10. Under section 50AAJ(6), the non-business loan condition is met if the actual provision relates to lending money otherwise than in the ordinary course of a business of lending money or an intra-group financing business.

11. The following factors will be considered when determining whether a company is carrying on an intra-group financing business, which is a question of fact–

- (a) the frequency, repetitiveness and the amount of the borrowing from and lending to the associated corporations of money;
- (b) whether there is borrowing from and lending to associated corporations of money at **commercial rates of interest**;
- (c) whether there is a degree of system and continuity of laying out and getting back of the loan of money by way of **interest** and repayment of principal;
- (d) the regularity and frequency of the payment of **interest** and repayment of principal;
- (e) whether a **profit is earned out of the interest differential** between the borrowing and lending; and
- (f) whether the **interest charged** on the borrowing and lending is on an **arm's length basis**.

12. Having regard to the above factors, we consider that a company merely engaging in providing interest-free loans with interest-free funds to associated enterprises **without** any motive to earn a profit from interest spread may **not** be regarded as carrying on an intra-group financing business. In any event, the no actual tax difference condition and the locality of interest should **not** be disregarded before deciding whether arm's length interest is to be imputed on the relevant company and whether such interest is chargeable to Hong Kong tax.

Safeguards against Tax Avoidance (Section 50 AAJ(7))

13. Under section 50AAJ(7), an actual provision has a tax avoidance purpose if the Commissioner of Inland Revenue (“the Commissioner”) is satisfied that the main purpose, or one of the main purposes, of the provision is to utilize a loss sustained by an affected person to avoid, postpone or reduce any liability, whether of the other affected person or any other person, to Hong Kong tax.

14. Section 50AAJ(7) is modelled on the existing section 16(2CC) of the Inland Revenue Ordinance (Cap. 112) (“IRO”)², with a view to ensuring that loss shifting arrangements will be subject to the TP rules. The adoption of such “main purpose test” in section 50AAJ(7) reflects the current international practice of using such test as one of the anti-avoidance measures. In fact, irrespective of the use of the “main purpose test” or the “sole or dominant purpose test” under the existing section 61A of the IRO, all relevant facts of the case have to be considered before reaching a conclusion under such tests. The “main purpose test” is **no more stringent** than the “sole or dominant purpose test”.

**Financial Services and the Treasury Bureau
Inland Revenue Department
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² Section 16(2CC) introduces the “main purpose test” for interest deduction in respect of the money borrowed by a corporation carrying on an intra-group financing business under section 16(2)(g) of the IRO. It provides that where the Commissioner is satisfied that the main purpose, or one of the main purposes, of the borrowing of money by the corporation from its non-Hong Kong associated corporation is to utilize a loss to avoid, postpone or reduce any liability, whether of the corporation or another person, to profits tax under the IRO, no deduction is to be allowed in respect of the interest payable on that money borrowed by the corporation.

**Draft Committee Stage Amendments to Section 50AAJ of
the Inland Revenue (Amendment) (No. 6) Bill 2017**

Marked-up Version

50AAJ. Interpretation: *potential advantage* in relation to tax

- (1) An actual provision confers a potential advantage in relation to Hong Kong tax or foreign tax on a person if, disregarding this Division, making or imposing the actual provision, instead of the arm's length provision, would in relation to Hong Kong tax or foreign tax (as the case requires) have either or both of the following effects—
 - (a) a smaller amount would be taken to be the amount of the person's income;
 - (b) a larger amount would be taken to be the amount of the person's loss.

- (2) Despite subsection (1), an actual provision made or imposed as between 2 persons is not taken to confer a potential advantage in relation to Hong Kong tax on either of the affected persons if—
 - (a) the domestic nature condition is met as provided for in subsection (3);
 - (b) either the no actual tax difference condition is met as provided for in subsection (5), or the non-business loan condition is met as provided for in subsection (6); and
 - (c) the actual provision does not, under subsection (7), have a tax avoidance purpose.

- (3) The domestic nature condition is met—
 - (a) if the actual provision is made or imposed in connection with each affected person's trade, profession or business carried on in Hong Kong; or

- (b) if—
- (i) the actual provision is made or imposed in connection with either affected person's trade, profession or business carried on in Hong Kong; and
 - (ii) the other affected person is resident for tax purposes in Hong Kong and the provision is not made or imposed in connection with that other person's trade, profession or business.
- (4) For the purposes of subsection (3), a trade, profession or business is not regarded as being carried on in Hong Kong by an affected person only because a sum received or receivable by or accrued to the person is deemed under section 15(1) to be a receipt arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong.
- (5) The no actual tax difference condition is met if—
- (a) each affected person's income arising from the relevant activities is chargeable to Hong Kong tax or each affected person's loss so arising is allowable for the purposes of Hong Kong tax; and
 - (b) no concession or exemption for Hong Kong tax applies to any affected person's income or loss arising from the relevant activities.
- (6) The non-business loan condition is met if the actual provision relates to lending money otherwise than in the ordinary course of a business of lending money or an intra-group financing business (as defined by section 16(3)).
- (7) For the purposes of this section, an actual provision has a tax avoidance purpose if the Commissioner is satisfied that the main purpose, or one of the main purposes, of the provision is to utilize a loss sustained by an affected person to avoid, postpone or reduce any liability, whether of the other affected person or any other person, to Hong Kong tax.
- (8) In this section—
relevant activities (有關活動) has the meaning given by section 50AAL.”.